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Monetary policy fundamentals for 2014

The monetary policy framework for 2014 sets mid-term monetary policy objectives and NBU performance figures, with the aim of maintaining the stability of Ukraine's national currency and achieving the goals set in the Law of Ukraine "On the National Bank of Ukraine," based on trends in, and judgments about economic, fiscal and monetary developments.

1. Monetary policy objectives for 2014 and for the mid term

Ukraine's legislation defines the primary objective of monetary policy as achievement and maintenance of price stability in the country. Monetary policy is considered successful if it maintains a low stable inflation rate on the CPI measure in the mid term (from 3 to 5 years).

The economic and political challenges that were facing Ukraine at the beginning of the year demonstrated the need for radical and unconventional measures to restore macroeconomic and financial stability, as well as the need for economic and social reforms. Making structural adjustments in the economy, bringing the prices of some products back to economically sound levels, providing wide-spread support to the banking system, together with other steps, will drive the inflation rate up in the short term. At the same time, these measures will put the economy back on the track to growth, restore stability in the financial system, thus delivering price stability in the mid term.

This said, in 2014, the National Bank will be involved in efforts to maintain CPI growth within the target of 12% set by the Government's forecast (December versus December of the previous year). In the mid term, the National Bank seeks to meet the CPI growth target of 3 to 5% a year.

According to Ukraine's law and to the extent that it does not threaten the stability of the national currency, monetary policy will also be aimed at delivering the banking system's stability (as a key element of maintaining financial stability), as well as at contributing to sustainable economic growth and supporting the government's economic policy. A decision regarding the effectiveness of the NBU's monetary policy and the Government's economic and financial policy will be taken on the basis of the criteria established in the relevant forecasts and programs for economic and social development.

2. Monetary policy in 2013 and the first quarter of 2014

In 2013, macroeconomic policy was aimed at maintaining consumer inflation close to zero. The year-on-year growth of the consumer price index ranged between minus 0.8% in March and April and 0.5% in December. This mostly resulted from a higher supply of food and a moderate rise in administrated prices.

A predictable UAH/USD exchange rate was one of the major contributors to the low inflation environment in 2013. Over that period, the interbank UAH/USD exchange rate dropped by 1.2%, to UAH 8.1508 per USD 1.

The stable exchange rate of hryvnia encouraged national currency savings. Total national currency deposits rose by 32.1% last year (by 16.1% in 2012), while foreign currency deposits dropped by 0.8% (in 2012 they increased by 19.2%). As a result, the level of deposit dollarization went down from 43.7% to 36.8%.

This drove monetary aggregates up at a fast pace, which, however, did not have an inflation-boosting effect for the reasons stated above. The monetary base expanded by 20.3% in 2013. The money supply increased by 17.6%, driven, among other things, by the multiplier effect.

Low inflation, however, did not prevent the build-up of external and internal imbalances in the economy. Thus, in 2013, the BOP current account recorded a deficit of 9.0% of GDP, which was not fully financed by borrowing on international markets. This affected international reserves, driving them down by USD 4.1 billion, to USD 20.4 billion (in the equivalent).

Structural adjustments in the economy failed to offset the impact of unfavorable global economic conditions on the real economy. As a result, real GDP demonstrated zero growth in 2013, versus 2012. The economic downturn took a toll on public finances: Ukraine’s state budget deficit was 4.4% of GDP in 2013.

Unfavorable macroeconomic trends continued into 2014 amid social and political tensions in the country. Industrial output declined by 5.0% in 2014. Export-oriented industries were affected the most.

Worsening economic and financial conditions brought an increase in prices, which, however, remained moderate, due to the sufficient supply of food on the market. This drove the CPI up by 3.4% year-on-year in March, compared to an increase of 0.5% for the whole of 2013.

The current account deficit dropped to USD 0.3 billion in January through February 2014, compared to a deficit of USD 1.6 billion in the same period of the previous year, due to sluggish economic activity and the depreciation of hryvnia. At the same time, the financial account deficit widened to USD 3.7 billion in January through February in the wake of the economic and political instability in the country. As a result, international reserves decreased by USD 5.3 billion in January through March 2014, to USD 15.1 billion.

In order to improve the competitive ability of the Ukrainian economy and to boost its resilience to external shocks a decision was made in February to adopt a flexible exchange rate regime. This had implications for exchange rates: in the first quarter of 2014, the hryvnia to dollar interbank exchange rate fell by 34.9%, to UAH 10.9981 per USD 1, while the hryvnia to dollar cash exchange rate dropped by 37.6%, to UAH 11.3971 per USD 1.

Economic and political tensions led to withdrawals of funds from banks. Thus, in January through March 2014, national currency household deposits declined by UAH 32.3 billion, while foreign currency deposits dropped by UAH 3.1 billion.

This demonstrated the need for the National Bank to take action to support banks' liquidity at a sufficiently high level to prevent a non-payment crisis, and to ensure that banks meet their obligations to depositors on time. To that end, the National Bank developed ad hoc liquidity support facilities for banks that had suffered from deposit withdrawals. In general, the National Bank granted UAH 63.1 billion worth of refinancing loans in the first quarter. As a result, over that period, the monetary base expanded faster (by 7.4%) than the money supply (by 3.8%).

Apart from that, over that period, the National Bank used interest rates to enhance the internal value of hryvnia, and regulated foreign exchange transactions by imposing temporary restrictions on foreign currency purchase.

In order to stabilize the situation and ensure financial stability is delivered and the economy is put back on the track to growth, the Government and the National Bank developed a special initiative, which could be financed by international financial institutions.

3. Main monetary policy tasks for 2014

Given the negative impact of internal and external factors, the main monetary policy task is to achieve stability in the financial and banking sectors, thus delivering price stability in the mid term.

The tasks are based on Ukraine's Cabinet of Ministers macroeconomic forecast, envisaging nominal GDP at UAH 1,574.3 million in 2014, real GDP negative growth at 3.0%, and CPI growth at 12.0% (December versus December of the previous year).

In the short term, prices may be significantly affected by the tough measures the Government is expected to take to address macroeconomic imbalances. The National Bank will, to a limited extent, use monetary policy tools to react to price changes, driven by decisions related to administrated prices, structural adjustments in the economy and external economic and political shocks. Although structural adjustments and price controls may lead to price volatility in the short term, in the mid term they should contribute to price stability by eliminating imbalances and boosting the performance indicators of related economic sectors.

With that in mind, the National Bank and the Government will make joint efforts to maintain CPI growth within the target of 12% set by the Government's forecast (December versus December of the previous year).

Monetary policy tools will be used mainly to deliver the stability of the national currency by regulating the size of the monetary base, which will be regarded as an operational target of monetary policy. Monetary base growth is not expected to be over 21% in 2014. Monetary base growth will depend on expected changes in the demand for money required to carry out business transactions (which is measured on the basis of the Government's estimated macroeconomic indicators), as well as on the need to give liquidity support to banks through NBU facilities, if market expectations temporarily deteriorate and banks face large deposit withdrawals. Other targets of monetary policy will include monetary performance criteria and recommended goals under IMF stand-by arrangements, as amended by reviews.

The size of the monetary base will be changed through legally prescribed monetary policy tools, which will be used to regulate the amount of liquid funds available to banks. Whether the monetary base will be expanded or contracted will depend on monetary conditions.

With high tensions on the money market, the NBU's main focus will be on providing liquidity support to banks to ensure the banks meet all obligations to their customers on time. This will ensure that payments in the economy are made on time, bolster confidence in the banking system, and deliver the right conditions for the return of deposits.

Over that period, banks' liquidity will be supported both through standard monetary policy tools and through ad hoc facilities designed to support banks that have suffered from deposit outflow. Given the uneven distribution of liquidity in the banking system, the National Bank will be actively involved in mobilization operations. The aim will be to redistribute a portion of funds in the banking system amid tensions and decreased market confidence.

The National Bank will act on the premise that the most efficient way to stabilize banking activity and to promote lending is to return to the banking system deposits (mostly household deposits) that were withdrawn when tensions rose. With that in mind, as tensions persist, the objective of interest rate policy will be to provide stimuli to the return of deposits to the banking system, and to help establish equilibrium on the foreign exchange market. This will be achieved by setting the discount rate and rates on standard monetary policy tools, as well as by setting higher rates for ad hoc facilities. The measures should encourage banks to manage their customer relations more effectively, and to repay refinancing loans as, or before, they fall due.

As the money market stabilizes and the return of deposits to the banking system is put firmly on track, the National Bank will stop using ad hoc mechanisms, and will return to standard monetary policy tools. Weekly refinancing tenders will be the main tool for managing banks' liquidity. Long-term mechanisms (reserve requirements) and one-time operations (purchase or sale of government securities) will be mainly employed to address liquidity mismatches. If there are no significant liquidity mismatches, the National Bank will give preference to short-term instruments.

The demand for, and supply of, liquid funds will be managed by

using interest rates to control the cost of funds. The discount rate will be charged for most refinancing loans. However, the price of refinancing loans may differ from the discount rate if the National Bank holds tenders that allow banks to suggest the price of refinancing loans themselves, or if there is a dramatic change in monetary conditions. Interest rate policy will be made more effective by imposing an interest rate band for overnight standing facilities. The rate on overnight certificates of deposit will be set as the bottom of the interest rate band, while the rate on overnight refinancing loans will be set as the top of the band;

regulating monetary operations, including by limiting the amount of scheduled operations, altering the list of eligible collateral, introducing additional requirements for banks that intend to use refinancing instruments to maintain their liquidity, as well as holding unscheduled tenders.

The adopted flexible exchange rate regime will further improve interest rate policy tools, boost the effectiveness of the transmission mechanism, and make the economy more resilient to external shocks. The official UAH/USD exchange rate will be set as the average rate on buy/sell transactions for non-cash dollars on the domestic market. The regime provides that the National Bank will intervene less in the interbank foreign exchange market. Given the need to make large payments related to the country's debt obligations, the National Bank will mostly intervene to purchase foreign exchange to increase international reserves. The National Bank will be involved in efforts to support and expand international reserves, including via diversification, taking into account conditions on the international foreign exchange and precious metal markets.

It will also take action to prevent transactions that can upset foreign exchange market equilibrium, initiate closer supervision over foreign exchange transactions, and make foreign exchange controls more effective.

As the major monetary policy objective is achieved, the National Bank will support the Government's efforts to revive economic growth. Here the main focus will be on delivering the right conditions for boosting bank lending to the real economy, and cutting interest rates. In particular, depending on money market conditions, the National Bank will consider providing the required monetary stimuli via monetary instruments. Steps taken to maintain the stability of the banking system will also promote bank lending. These steps include improving Ukraine's laws related to corporate governance and risk management in banks, further increasing the protection of creditors' rights, decreasing the amount of banks' non-performing assets, as well as injecting capital into banks.

With the view of fostering economic growth through a build-up of funds in the financial system, the National Bank will work on promoting cashless payments. To that end, it will foster cashless payments that are effected using electronic payment instruments, introduce modern technologies to ensure that settlement agents are given reliable and effective service, establish a unified infrastructure, and implement related social projects. Appropriate oversight over payment and settlement systems will help ensure their continuity, and enhance the transparency of financial transactions.

The National Bank will closely cooperate with the government in order to align monetary policy with financial policy. Among other things, they will focus on the impact the issue of government bonds will have on the money market, as well as on issues related to providing financial system stability and improving financial instruments. The National Bank will also be involved in joint efforts with all branches of the government to deliver macroeconomic stability, update Ukraine's laws related to the protection of creditors and financial services consumers' rights, improve the investment climate, as well as to introduce better legal proceedings for resolving credit disputes.

4. Key implementation principles and tasks of the mid-term monetary policy

Mid-term monetary policy strategy will envisage introduction of the inflation targeting regime, which should be finalized in the second half of 2015. This monetary regime will be based on the following principles:

- absolute priority of price stability over other monetary policy goals and tasks. Under the law, the year-on-year CPI shall be the criterion to assess the achievement of the monetary policy main objective. Also, in order to perform a comprehensive analysis of inflation, some other price indices will be monitored (core consumer price index, producer price index, GDP deflator);

tactical flexibility and commitment to mid-term objectives. A temporary deviation of the consumer price index growth from the targets is acceptable if it is due to the structural developments in the economy, adjustment of individual prices and tariffs to the economically justified levels, influence of major external factors, etc. Reasons for monetary policy adjustments shall be, first of all, the factors potentially capable to change mid-term inflation trends;

no commitments undertaken by the National Bank of Ukraine to keep the hryvnia to foreign currencies exchange rate at a certain level or within a band. The official UAH/USD rate shall be set on the basis of its quotations in the interbank market, contributing to impartial public assessment of currency risks. At the same time, as the hryvnia exchange rate bears considerably on the inflation rate and the quality of bank balance sheets, indicators of the UAH exchange rate and real effective exchange rate developments shall be deemed important for making regulatory decisions;

decision-making potential. Need for regulatory monetary measures shall be defined on the basis of inflation estimate, as well as forecasts for the real sector growth, balance of payments and monetary market development on the basis of analysis of a wide range of macroeconomic, budgetary and monetary indicators, their interaction and impact on hryvnia stability, taking into account possible further changes;

transparency of the National Bank of Ukraine activities. Detailed explanation of the reasons and actions of the National Bank related to the monetary market shall be both provided right after the decision is made (press-releases, video addresses, briefings etc.) and summarized in the National Bank of Ukraine official analytical documents to be regularly published on the NBU official website.

Preparation to introduction of inflation targeting implies measures to be taken along the following lines:

improvement of institutional framework for the activities of the National Bank of Ukraine. Main efforts will be aimed at strengthening its independence (including use of own estimates for determining inflation targets and drafting monetary policy) and at streamlining the monetary decision making process. Amendments to the Ukrainian legislation will be initiated if needed;

improvement of the operational structure of the monetary policy. Main efforts will be focused on strengthening interest rate's influence on monetary market and turning the interest rate into the main instrument and operational benchmark of the monetary policy, facilitated by the flexible exchange rate regime. For this goal to be effectively accomplished, the financial system shall reach higher progress level and transmitting mechanisms shall be more efficient. Before interest rate instruments gain necessary level of efficiency, quantitative indicators of money supply shall play key role in the process of monetary regulation. Until complete implementation of the inflation targeting, the main operational monetary benchmark shall be dynamics of the monetary base indicator;

improvement of communication. Main efforts here shall be aimed at higher transparency of decision-making, which will imply public access to broader range of information about the reasons and grounds for regulatory decisions.

Ensuring long-term macroeconomic stability requires creating systemic prerequisites to support steady low-inflation environment and strengthening hryvnia resilience to internal and external shocks. Such work will be done along the following key lines.

1. Facilitating domestic financial market development and ensuring its sustainability. This will allow to reduce dependence of the economy and monetary area on external borrowings, create sound and reliable sources of long-term financing and improve operation of monetary transmitting mechanisms.

Following its legal mandate, the National Bank of Ukraine will focus primarily on contributing to stability of the banking system and strengthening its lending and investing capacity. Also, in cooperation with the Government and other financial regulators, a financial stability monitoring system shall be established assessing systemic risks, performing macroprudential analysis and building-up a macro stress-testing system. The National Bank is supposed to be actively engaged in developing the stock market, including promoting its organized segment and ensuring efficient operation of the national depository system. Also, the measures will be taken to develop techniques for currency risk hedging, including amendments to the Ukrainian laws regulating the issuance and circulation of derivatives.

2. Efficient international reserves management and flexible use of their stabilizing capacity. In view of the high external debt (including public debt), it is necessary to keep on increasing international reserves and maintain them at the level ensuring adequate protection of domestic economy and currency from external shocks. On the other hand, flexible exchange rate regime will reduce potential need in international reserves.

Due to their stabilizing role, the international reserves will be always changing in volume: when the situation in the market is better, they will pile up, whereas at the times of higher external pressure they can be used for absorbing destabilizing developments. If needed, international reserves will be used for mitigating surge pressures on the foreign exchange market at the maturing external liabilities of the state and economic entities.

3. Optimization of foreign currency restrictions and ensuring their adequacy to the level of domestic and external threats to stability of the Ukrainian currency. The foreign currency restrictions system will be amended based on the principle of reasonable sufficiency taking into account the economy and financial markets development levels. The regulatory measures in this area will depend on the key factors forming financial base for redeeming and servicing external debt of the state and economic entities, primarily economic growth rates, growth in demand for Ukrainian currency, lowering dollarization in economic relations etc. Economic

recovery and rise in demand for the domestic currency will encourage further liberalization of the foreign exchange market. However, in the event of adverse macroeconomic developments and the balance of payments deterioration, temporary tightening of foreign exchange restrictions might be necessary. Such measures might be taken in case of realization of some risks or proactively for early prevention of undesirable developments.

Effective fulfillment of the tasks related to creating systemic grounds for the long-term currency stability requires close cooperation and coordination of the National Bank actions with all branches of government. It is needed, in particular, for ensuring macroeconomic stability support, depositors' and creditors' rights protection, favorable investment climate etc. Such work implies an active role of the National Bank of Ukraine during the preparation of the nation-wide forecasts and program documents, draft laws and regulations, and participation in implementation of the related measures.

The measures will also be taken to enhance public confidence and support of the policy of the National Bank of Ukraine. For that purpose the National Bank of Ukraine will further improve the system of public communication. Communication of monetary policy objectives and measures needed for their achievement, as well as shaping positive expectations in the market, will be done through all available informational channels. Further efforts will be made to improve public financial literacy. Following the rise of the public awareness of financial markets operation, the focus will be shifted to popularization of the most recent investment instruments and cashless settlements. It will facilitate development of the domestic financial market and, later on, less reliance of the Ukrainian economy on external financial resources.